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THE O.N. EQUITY SALES COMPANY

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

THE O.N. EQUITY SALES COMPANY, an Ohio Corporation,

Plaintiff,

vs.

DANIEL MARIA CUI, an individual,

Defendant.

Civil Action No. C-07-2844 JSW

(E-FILING)

PLAINTIFF'S NOTICE OF MOTION AND MOTION FOR PRELIMINARY INJUNCTION; MEMORANDUM IN SUPPORT

[E-Filed concurrently with [Proposed] Order]

DATE: TBD
TIME: TBD
CTRM: 2, 17th Floor
Hon. Jeffrey S. White

Complaint filed: May 31, 2007
Trial date: None

TO THE COURT AND ALL PARTIES AND THEIR COUNSEL OF RECORD:

PLEASE TAKE NOTICE THAT that, at a date and time to be determined, in the courtroom of the Honorable Jeffrey S. White, located at 450 Golden Gate Ave., Seventeenth Floor, San Francisco, California 94102, Plaintiff the O.N. Equity Sales Company ("ONESCO") will and hereby does move, pursuant to Rule 65 of the Federal Rules of Civil Procedure, for a preliminary and permanent injunction enjoining Defendant Daniel Maria Cui ("Maria Cui") from taking any further action with respect to Case No. 07-00936 filed with the National Association of Securities Dealers in or about March 2007, and amended on April 3, 2007.

ONESCO has filed its Motion to Consolidate Preliminary Injunction Hearing with Trial on the Merits, and its Motion for an Order Authorizing the Parties to Engage in Immediate Discovery, both to be heard on October 12, 2007. In addition, the instant motion for preliminary injunction requests that the parties be allowed a reasonable time before the hearing of the preliminary injunction motion to conduct discovery into the issues identified. ONESCO believes that an appropriate time and date for the hearing on this motion can and should be determined by the Court and the parties after the Court has considered the Motion to Consolidate. Consequently, and after conferring with the Clerk of the Court on this issue, this motion has not been noticed for hearing on a specific time and date.

This motion is based on the memorandum of points and authorities in support hereof, the exhibits attached to this motion, the pleadings, records and papers on file herein and such other and further evidence and argument as may be presented at or before the hearing.

Respectfully submitted,

Dated: September 6, 2007

ZEIGER, TIGGES & LITTLE LLP

By: /s/
Michael R. Reed

Attorneys for Plaintiff
THE O.N. EQUITY SALES COMPANY

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MEMORANDUM IN SUPPORT

I. INTRODUCTION

> *"[NASD customer status for purposes of arbitrability should] be determined as of the time of the occurrence of events that constitute the factual predicate for the causes of action contained in the arbitration complaint. ... We cannot imagine that any NASD member would have contemplated that its NASD membership would require it to arbitrate claims which arose while a claimant was a customer of another member merely because the claimant subsequently became its customer."*

[*Wheat, First Sec., Inc. v. Green*, 993 F.2d 814, 820 (11th Cir. 1993) (emphasis added).]

This holding applies with equal force to the instant case. Defendant, who invested in a private placement unrelated to ONESCO, seeks to arbitrate claims against ONESCO before the National Association of Securities Dealers, Inc. ("NASD"). Yet Defendant does not have a written agreement to arbitrate any dispute between himself and ONESCO and, indeed, had no business relationship with ONESCO at all. Defendant's only conceivable ground for arbitration is that he entered into an investment transaction with a Trust whose Trustee *later* became an "associated person" with ONESCO. But applying the NASD Rules to the facts of this case, Defendant cannot compel arbitration.

As *Wheat* and other cases consistently hold, NASD "customer" status for purposes of bringing claims in arbitration is determined "as of the time of the occurrence of the events that constitute the factual predicate for the causes of action." *Wheat*, 993 F.2d at 820. In a securities action based on alleged misrepresentations or omissions, the factual predicate is the material misrepresentation or omission that induces the investments in question – not subsequent payments or additional transactions premised on the same original misrepresentations. *See, e.g., Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991) (concluding that statute of repose for a Rule 10b-5 claim starts from the date of the alleged misrepresentation inducing a sale, not from the date of sale itself); *Asdar Group v. Pillsbury, Madison & Sutro*, 99 F.3d 289, 294-95 (9th Cir. 1996) ("the statute ordinarily begins to run … when a person commits the act that gives rise to liability under that section").

Here, although Defendant asserts a number of state and federal causes of action, his

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NASD statement of claim reveals that all of his claims are fundamentally based on alleged material misrepresentations and omissions that induced his decision to invest in the Lancorp Fund. For instance, in paragraph 39 of his first amended statement of claim, Defendant alleges that "Respondent ONESCO, acting through Lancaster, *recommended* that Claimants invest in … [an] unregistered, fraudulent investment …" [*See* First Amended Statement of Claim, at 16 (emphasis added) (Compl. Exh. A).] At paragraph 40, Defendant alleges that "Respondent ONESCO, acting through Lancaster, made numerous false representations to Claimants concerning this Lancorp Financial Fund Business Trust … and Megafund Corporation … investment." [*Id.* at 17] And in paragraphs 41 to 45, Defendant accuses ONESCO, acting through Lancaster, of making numerous other misrepresentations or omissions with respect to the risks associated with and operations of the Lancorp Fund. [*Id.* at 18-20.]

As the Northern District of Georgia explained in a recent case, "if the sale occurred at a time when [the associated person] was not employed by [the member], the latter cannot be hauled into an arbitration proceeding … ." *Hornor, Townsend & Kent, Inc. v. Hamilton*, 2004 WL 2284503, at *3 (N.D. Ga., Sept. 30, 2004) (Exh. F). This is because an NASD member "could not have supervised [the associated person] at a time before [the associated person] became employed with" the NASD member. *Hornor, Townsend & Kent, Inc. v. Hamilton*, Case No. 1:01-cv-02979 (N.D. Ga., Sept. 6, 2005) (slip op., at 12) (Exh. G). *Accord: Prudential Sec., Inc. v. Dusch*, 1994 WL 374425 (S.D. Cal., Mar. 28, 1994) (Exh. H) (enjoining arbitration brought by investor over transactions occurring before investor became the customer of an NASD member); *Gruntal & Co., Inc. v. Steinberg*, 854 F. Supp. 324, 340 (D.N.J. 1994) (same).

Simply put, at the time of the occurrence of the events giving rise to his claims, Defendant was not dealing with an "associated person" of ONESCO. As a result, he may not avail himself of the right to arbitrate under the NASD Rules. Injunctive relief is appropriate because, as the Ninth Circuit has held, a party is irreparably harmed if it is forced to arbitrate a dispute where it had no contractual obligation to do so. *See, e.g., Textile Unlimited, Inc. v. A..BMH and Co. Inc.*, 240 F.3d 781, 786 (9th Cir. 2001). ONESCO therefore respectfully requests this Court to schedule this matter for a preliminary injunction hearing and thereafter enjoin Defendant from

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proceeding further in NASD Case No. 07-00936.

II. STATEMENT OF FACTS

A. Brief Overview of ONESCO and Non-Party Lancaster.

ONESCO is a full service retail broker-dealer registered in all 50 states. ONESCO, through its more than 1,000 registered representatives, offers a variety of investment products, including standard brokerage services; mutual funds; variable insurance products; and Section 529 plans.

Non-party Gary Lancaster ("Lancaster") was a registered representative with ONESCO, on an independent contractor basis, from March 23, 2004 to January 3, 2005. [*See* Exh. A, Form U-5 for Gary Lancaster; Exh. B, Affidavit of Jeffrey Bley.] Prior to his affiliation with ONESCO, Lancaster was an experienced insurance salesman and investment representative. He had prior experience as a registered representative with BA Investment Services, Inc., Piper Jaffray, Inc., and Quick & Reilly, Inc.[1] As Lancaster's Central Registration Depository statement ("CRD", at Exh. A) makes clear, his record was free of regulatory issues before he joined ONESCO as an independent contractor.

At the inception of his relationship with ONESCO, Lancaster disclosed his involvement with two other businesses unrelated to the business of ONESCO. First, Lancaster disclosed his position as an Account Executive with Universal Underwriters Group. [*See* Exh. C, Other Business Disclosure Reporting Page.] He described the nature of this business as "property – casualty, Life and Health Sales-Service." [*Id.*] Second, Lancaster disclosed his position as President of Lancorp Financial Group, LLC. [*Id.*] Again, Lancaster described his role with this entity as "sales and service life, health, annuities." [*Id.*] These disclosures were reviewed by ONESCO's Contracting and Licensing group.

During his tenure as an independent contractor with ONESCO, Lancaster failed to generate any business for ONESCO. In fact, he generated no commission revenue during his

[1] Lancaster was involuntarily terminated by Piper Jaffray, and its parent company, U.S. Bancorp, in September 2002; however, the Form U-5 submitted by that firm expressly states that his termination was "*not sales practice related*." [*See* Lancaster CRD, at 4.]

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entire ten-month relationship with ONESCO. As a result, ONESCO terminated its relationship with Lancaster on January 3, 2005, pursuant to a firm policy that requires representatives to generate at least $10,000 in annual commission revenue.

B. The Lancorp Financial Fund Business Trust Transactions.

The genesis of this case is Defendant's investment, through Lancaster, in a *private placement* offered by the Lancorp Financial Fund Business Trust (the "Lancorp Fund"), a Nevada Business Trust unaffiliated with ONESCO.[2] Lancaster served as Trustee of the Lancorp Fund. *As the NASD expressly recognized in its August 10, 2006 Letter of Acceptance, Waiver and Consent Agreement with Lancaster, Lancaster never disclosed his involvement with the Lancorp Fund to ONESCO.* [*See* Exh. D, Letter of Acceptance, No. 20050034080-01.]

As part of this private placement offering, the Lancorp Fund prepared a detailed Private Placement Memorandum, a copy of which is attached to the Complaint as Exhibit A. Prior to investing in Lancorp, all potential investors, *including Defendant*, were required to review this Memorandum and execute a Subscription Agreement.

The Private Placement Memorandum stated that the Lancorp Fund was "an unregistered, closed-end non-diversified management investment company." [Lancorp Private Placement Memorandum, at introduction.] Its investment objective involved "the issuance of Forward Commitments … to large financial institutions relating to debt securities bearing interest or sold at a discount …." [*Id.*] From records recovered from the court appointed receiver in *Securities and Exchange Commission v. Megafund Corporation*, Case No. 3:05-CV-1328-L (N.D. Texas), it appears Lancaster invested significant dollars from the Lancorp Fund in Megafund, later revealed as a Texas-based Ponzi scheme. As a result of these investments, many of the Lancorp Fund investors suffered significant losses, and the Lancorp Fund was placed in receivership.

Investors in the Lancorp Fund, including Defendant, were not customers of ONESCO, and their investments in the Lancorp Fund were not the type of investments offered by ONESCO through its registered representatives. In fact, the Lancorp Fund's Private Placement

[2] The information set forth herein relating to the Lancorp Fund, Defendant, and Lancaster is based, in part, on the investigation conducted to date.

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Memorandum reveals, in numerous respects, that Defendant was a sophisticated investor who *knew* that the Lancorp Fund investments were not sold by ONESCO; that such investments were not registered with the Securities and Exchange Commission; and that Lancaster, in selling such investments, was not acting on behalf of or with the authorization of ONESCO.

1. Defendant Was A Sophisticated Investor.

In order to invest in the Lancorp Fund, each investor was *required* to certify and demonstrate that he or she qualified as either an "accredited" investor, or as a "sophisticated, well-informed investor." To qualify as an "accredited investor," an investor in the Lancorp Fund had to demonstrate, in pertinent part, that he or she:

> is a natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000; [or] ... is a natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; [or] ... any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person ...

[Placement Memorandum, at 9 (citing Regulation D, 1933 Securities Exchange Act).]

To qualify as a "sophisticated, well-informed investor," the investor had to provide the Lancorp Fund with "reasonable grounds to believe":

- That he is a sophisticated, well-informed investor and is able to understand and utilize the information contained herein, or is represented by a Purchaser Representative;
- That he or his Purchaser Representative has knowledge and experience in financial and business matters and is capable of evaluating the merits and risks of the investment in the Trust;
- That he has financial strength and experience in investment transactions and is able to bear the economic risk of the investment in the Trust; and
- That he understands the necessity of compliance with the foregoing.

[Private Placement Memorandum, at p. i.]

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Of the maximum 100 investors permitted in the Lancorp Fund, no more than 35 were to be "non-accredited," but otherwise *sophisticated* investors. [*Id.* at 9.]

As "accredited" or "sophisticated" investors, each investor also certified his or her knowledge of the inherent risks involved with this private placement transaction. Specifically, they acknowledged that:

- The [Lancorp Fund] is newly organized and has limited development capital and experience.
- This investment is suitable only for investors having substantial financial resources and who desire at least a one-year investment.
- Except for certain redemption rights, the Investor Shares will not be transferable.
- The Investor Shares will have limited voting rights as specified in the Declaration of Trust and Bylaws.

[Private Placement Memorandum, at p. i.]

In other words, the investors were all sophisticated investors who were well aware of the risks associated with their investments in the Lancorp Fund private placement. This is reflected in the related transactional paperwork. Defendant certified that he "has made other risk capital investments or other investments of a speculative nature, … by reason of his business and financial experience" and "has carefully evaluated his financial resources and investments and acknowledges that he is able to bear the economic risks of this investment." [Exh. E, Subscription Agreement, Section 2(p), at p. SB-9.]

2. The Lancorp Fund Expressly Disclaimed Any Relationship With A Broker-Dealer, In Numerous Instances.

As a sophisticated investor who executed his respective copy of the Private Placement Memorandum before Lancaster was affiliated with ONESCO, Defendant also acknowledged that the Lancorp Fund was managed exclusively by its Trustees and that it had no relationship of any kind with a broker-dealer or other investment advisor. As stated at page 7 of the Memorandum, "[t]he Trust will not be managed like a typical closed-end investment company. The Trust will be internally managed by the Trustees and *will not have any separate investment advisor*."

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More importantly, the Private Placement Memorandum emphasized, in two separate instances, that investments in the Lancorp Fund were offered and sold *without the assistance of any broker-dealer or other selling agent*. First, at page 4, the Memorandum expressly stated:

> This offering is a "best efforts" and "minimum-maximum" offering by the Trust, *without the assistance of any broker-dealer or any other selling agent*. . . .

[Private Placement Memorandum, at p. 4 (emphasis added).]

Then, at page 12, the Memorandum re-emphasized this specific point:

> **No Broker-Dealer**
>
> The Investor Shares will be sold on a "best efforts" *by the Trust without the assistance of any broker-dealer or selling agent* subject to our right to reject any offer to purchase an Investor Share in whole or in part. There is no firm commitment on the part of the Trust or any other party to purchase any of the Investor Shares not otherwise sold in this offering.

[Private Placement Memorandum, at p. 12 (emphasis added).]

In fact, if the investors sought the assistance of their own purchaser representative in evaluating the merits of investing in the Lancorp Fund, they were required to:

> complete and return to the Trust a Purchaser Representative Questionnaire … The Trust will [then] evaluate the qualifications of each proposed Purchaser Representative and will notify the prospective investor as to the acceptability of such person as a Purchaser Representative. Each Purchaser Representative will be required to disclose to the prospective investor whom he represents any past, present or proposed future relationship of such Purchaser Representative with the Trust or any of its subsidiaries, or any other party of this offering.

[Private Placement Memorandum, at p. 9.]

It is evident from these numerous, express disclosures (all of which were made prior to Lancaster's affiliation with ONESCO) that Defendant was aware that his investment in the Lancorp Fund was sold directly by the Fund. And Defendant was clearly aware that no broker-dealer or any other selling agent had *any involvement* in the sale of such investments.

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3. Defendants Knew That Lancaster Was Not Acting On Behalf Of ONESCO.

Also noteworthy are Lancaster's personal disclosures in the Private Placement Memorandum, which made clear he was not affiliated with ONESCO. Lancaster, as Trustee of the Lancorp Fund, described himself in the following manner:

> Gary L. Lancaster has spent the majority of his professional career in the specialized field of trust administration, financial consulting, and asset management. He has been the Fund's Trustee since its formation on December 9, 2002. From 1995 to 1996, Mr. Lancaster was a planning officer and retirement specialist handling investments, estate planning, and trusts with First Interstate Bank - Wells Fargo/Stephens, Inc. From 1997 to 1999, he was an insurance specialist in investments, estate planning and trusts for BA Financial Services, Inc. *Since 1999 Mr. Lancaster has been employed as a vice president of financial services and a financial consultant of U.S. Bancorp, an affiliate of the Escrow Agent under this memorandum. Since June 1996, Mr. Lancaster has been the owner of Lancorp Financial Group, LLC. Mr. Lancaster is an investment adviser registered with the Commission under the Investment Advisers Act of 1940, as amended.*

[Private Placement Memorandum, at p. 15 (emphasis added).]

Noticeably absent from this disclosure is *any mention of ONESCO*, or Lancaster's relationship therewith. Indeed, at this point there was no such relationship.

Simply put, Defendant, who executed a copy of the Private Placement Memorandum, had no indication and, thus, *no reason to believe* that ONESCO had anything to do with the Lancorp Fund or Lancaster's sale of investments therein. To the contrary, the above provisions reveal that Defendant knew that his investment in the Lancorp Fund was a private placement, offered directly by the Lancorp Fund and Lancaster as its Trustee, *without the assistance or authorization of any broker-dealer, including ONESCO*.

C. Defendants' Purchases.

Defendant never established any form of contractual or customer relationship with ONESCO. Rather, all of his dealings were solely with Lancorp Fund. Moreover, significantly, the information recovered to date by ONESCO reveals that Defendant entered into the Subscription Agreement *prior to* Lancaster becoming an "associated person" of ONESCO. Lancaster's registration with ONESCO was from March 23, 2004 to January 3, 2005, but the

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Defendant executed his subscription agreement well before then: he executed it nearly eight months earlier on July 30, 2003.[3] [Exh. E (Subscription Agreement, executed 7/30/03).] Under

[3] The First Amended Statement of Claim filed with the NASD avoids any mention of the events occurring on or before July 30, 2003. This is not the first time a claimed event date in an NASD action pursued by Defendant's counsel has turned out to be wrong. In Hornor, Townsend & Kent, Inc. v. Hamilton, 218 F. Supp. 2d 1369 (N.D. Ga. 2002), the same law firm representing Defendant in this case represented investors attempting to force arbitration against an NASD member. In the opinion cited, the investors secured an order from the court denying a motion by Hornor Townsend, the plaintiff broker-dealer, for an injunction and allowing arbitration to proceed. The court's decision was based on a sworn statement by the defendant investors that a transaction the investors claimed was subject to arbitration had occurred on October 1, 1999 – three weeks after the sales representative with whom they had dealt became associated with Hornor Townsend.

Later, during discovery in the arbitration, Hornor Townsend learned that the transaction in question had actually occurred on August 2, 1999 – more than a month *before* the sales representative became its associated person – not on October 1, as the investors had represented. After Horner Townsend presented this new evidence to the court, the court granted reconsideration of judgment, conditioned upon remand of an appeal of the arbitrability issue from the Eleventh Circuit. *See Horner, Townsend & Kent, Inc. v. Hamilton*, 2003 WL 23832424 (N.D. Ga., Sept. 29, 2003) (Exh. I). The court expressed its concern that the defendants had misrepresented the purchase date in their affidavit in order to make their claim arbitrable. *Id.* at *10-11. In a subsequent decision granting reconsideration after remand, the court also granted defendants' motion for correction, based on counsel's statement that the error was not intentional: "The Court accepts defense counsel, Mr. Goodman's representation, and hereby grants his motion to correct, to the extent that the Court indicates that plaintiff has not established an intentional misrepresentation by defense counsel … ." *Horner, Townsend & Kent, Inc. v. Hamilton*, 2004 WL 2284503, at *9 (N.D. Ga., Sept. 30, 2004) (Exh. F).

Nevertheless, the investors continued to try to force arbitration by means of various arguments that arbitrability was not controlled by NASD "customer" status on the transaction date, as ample case authorities hold, but, rather as of the dates of subsequent events arising from a contractual relationship. In a fourth order in that case, the court granted summary judgment to Horner Townsend, ruling the claim not arbitrable. *See Hornor, Townsend & Kent, Inc. v. Hamilton*, Case No. 1:01-cv-02979 (N.D. Ga., Sept. 6, 2005) (slip op.) (Exh. G). In that order, the court issued a final ruling that claims arising from events occurring prior to the August 2, 1999, transaction were not arbitrable, noting that "[d]efendants try mightily to date their first investment after September 11, 1999 – the date on which Tommy Fountain became associated with plaintiff – in an understandable effort to tie plaintiff to Fountain and thereby force plaintiff to an arbitration." *Id.*, slip op., at 9. However, the court was not persuaded, and it commented that:

> The failure of defendants' counsel to alert the Court originally to the existence of this August 2nd purchase date and the drafting inconsistencies now apparent in defendants' original description of the purchase dates strongly suggest that even defendants' counsel recognize the weakness of their present argument. Otherwise, they would have aired all of these matters when they were originally before the Court instead of the Court having to learn all of this only after plaintiff later received discovery material that brought to light the existence of an earlier purchase date than that represented by counsel.

[*Id.*, slip op., at 10.]

As evidenced by the written materials submitted herewith, several of the "dates" set forth in the Statement of Claim are inaccurate. The events giving rise to Defendant's claims occurred before Lancaster was affiliated with ONESCO.

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the terms of the contract, Defendant's tendering of funds into escrow operated to make his commitment to purchase shares "irrevocable" as of that date. [Subscription Agreement, § 1(d).] It logically follows that any alleged material misrepresentations that induced Defendant's execution of the subscription agreement (i.e., his irrevocable commitment to purchase) must have occurred on or before that date.

ONESCO's preliminary review reveals some activity post-execution of the Subscription Agreements, however, much of this activity occurred *after* Lancaster was terminated by ONESCO on January 3, 2005. For example, Defendant apparently made a payment of $1,241.96 on April 22, 2005 – more than three months after Lancaster's termination from ONESCO – and, according to Defendant's own Statement of Claim, Defendant made a $200,000 payment on September 6, 2005. Based on the information recovered to date, however, Defendant's subsequent actions were premised on the same alleged misrepresentations and omissions that led to his July 30, 2003, contractual commitment, including the written materials and disclosures received before July 2003. At this point, ONESCO submits that Defendant's claims relating to the July 30, 2003, subscription agreement and the alleged misrepresentations that induced Defendant's execution of it are not arbitrable under any circumstances, and evidence that will be offered at hearing will demonstrate that the subsequent payments occurred outside of Lancaster's tenure with ONESCO and were otherwise predicated on conduct pre-dating the execution of the Subscription Agreement. Specifically, ONESCO anticipates that evidence to be gathered through discovery and offered at hearing will demonstrate that subsequent representations, if any, were not new or material with respect to the Defendants' investment decisions. Thus, as explained below, ONESCO has no obligation to arbitrate these claims.

D. Defendants' Arbitration Action.

In or about March 2007, non-party Marc E. Robertson ("Robertson") initiated an action with the National Association of Securities Dealers, Inc. (Case No. 07-00936) against ONESCO, wherein he seeks to hold ONESCO responsible for the alleged misrepresentations Lancaster made in the Private Placement Memorandum, discussed herein, and other alleged misrepresentations, on the grounds that, generally, Lancaster was associated with ONESCO, and ONESCO

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negligently supervised Lancaster. Robertson filed an Amended Statement of Claim, adding Defendant and others as Claimants in the same NASD action, on or about April 3, 2007. Claims are brought under federal and state securities law, violations of state consumer protection statutes, breach of contract, common law fraud, breach of fiduciary duty, and negligence and gross negligence.

III. LAW AND DISCUSSION

In an action seeking to enjoin an arbitration proceeding, the traditional equitable criteria for granting injunctive relief apply. These factors are: "(1) a strong likelihood of success on the merits; (2) the possibility of irreparable injury to the plaintiffs if injunctive relief is not granted; (3) a balance of hardships favoring the plaintiffs; and (4) advancement of the public interest." *Textile Unlimited, Inc. v. A..BMH and Co. Inc.*, 240 F.3d 781, 786 (9th Cir. 2001). We address each of these elements.

A. ONESCO Has A Strong Likelihood Of Success On The Merits.

1. Arbitration Is Solely A Matter Of Contract, And Parties May Not Be Forced To Arbitrate Disputes They Did Not Agree To Arbitrate.

The Federal Arbitration Act ("FAA"), 9 U.S.C. §§ 1 *et seq.*, governs arbitration disputes involving interstate commerce. Although the public policy embodied in the FAA favors arbitration in resolving disputes, above all:

> [A]rbitration is a matter of contract, and a party cannot be required to submit to arbitration any dispute which he has not agreed to so submit.

[*AT&T Tech., Inc. v. Communications Workers of America*, 475 U.S. 643, 648 (1986).][4]

Because arbitration is, at its core, a matter of contract, courts must take care to ensure that they do not force a party to arbitrate a dispute that it never agreed to arbitrate. "[T]he first task of a court asked to compel arbitration of a dispute is to determine whether the parties agreed to arbitrate that dispute." *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985).

[4] California law is identical. See *Pacific Investment Co. v. Townsend*, 58 Cal.App.3d 1, 9 (Ct. App. 1976) ("Arbitration is a matter of contract and a party cannot be required to arbitrate a dispute he has not agreed to submit.").

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In *Volt Info. Sciences, Inc. v. Stanford Univ.*, 489 U.S. 468, 469 (1989), the United States Supreme Court squarely recognized that "[a]rbitration under the act is a matter of consent, not coercion, and parties are generally free to structure their arbitration agreements as they see fit … [and] they may limit by contract the issues which they will arbitrate." *Accord: First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938 (1995) ("Arbitration is simply a matter of contract between the parties; it is a way to resolve disputes – but only those disputes – the parties have agreed to submit to arbitration."); *Sanford v. Memberworks, Inc.*, 483 F.3d 956, 962 (9th Cir. 2007) ("It is axiomatic that … a party cannot be required to submit any dispute which he has not agreed so to submit."); *Wiepking v. Prudential-Bache Sec., Inc.*, 940 F.2d 996, 998 (6th Cir. 1991) ("An agreement to arbitrate is a contract … [I]t does not prevent parties from agreeing to exclude matters from arbitration if they so desire."). Thus, if one party seeks to force another to arbitrate a dispute the parties did not agree to submit to arbitration, the proper remedy is to enjoin the arbitration.[5]

2. Whether An Agreement To Arbitrate Exists Is For The Court To Decide.

The question of "whether or not a company is bound to arbitrate, as well as what issues it must arbitrate, is a matter to be determined by the Court." *Litton Fin. Printing Div. v. Nat'l Labor Relations Bd.*, 501 U.S. 190, 208 (1991). *See also AT&T Tech.*, 475 U.S. at 649 (determining whether a contract creates a duty to arbitrate a particular matter is an issue for the courts to decide); *Sanford v. Memberworks, Inc.*, 483 F.3d at 962 ("[C]hallenges to the *existence* of a contract as a whole must be determined by the court … ."); *Three Valleys Mun. Water Dist. v. E.F. Hutton & Co., Inc.*, 925 F.2d 1136, 1141 (9th Cir. 1991) ("The court must determine whether a contract *ever* existed; unless that issue is decided in favor of the party seeking arbitration, there is no basis for submitting a question to an arbitrator.") (citation omitted).

[5] In each of the following cases, for example, the courts issued injunctions to preclude arbitration where the disputes at issue were not arbitrable. *Textile Unlimited*, 240 F.3d 781 (9th Cir. 2001); *LAWI/CSA Consolidators*, 849 F.2d 1236 (9th Cir. 1988); *Six Clinics Holding Corp. v. Cafcomb Systems*, Inc., 119 F.3d 393 (6th Cir. 1997); *Md. Cas. Co. v. Realty Advisory Bd.*, 107 F.3d 979 (2nd Cir. 1997); Va. *Carolina Tools, Inc. v. Int'l Tool Supply, Inc.*, 984 F.2d 113 (4th Cir. 1993); *United Offshore Co. v. Southern Deepwater Pipeline Co.*, 899 F.2d 405 (5th Cir. 1990).

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3. No Agreement Exists Between the Parties To Arbitrate Their Disputes.

As an initial point, Defendant does not contend – nor can he – that he has an express agreement with ONESCO to arbitrate any disputes between them.

4. Defendants' Claims Are Not Arbitrable Under NASD Rules Because Defendant Was Not A Customer Of ONESCO Or Any Of Its Associated Persons At The Time Of The Events Giving Rise To His Claims.

a. Defendant's Only Claimed Basis For Arbitrability Of This Dispute Lies In The NASD Rules.

The only possible grounds for arbitration is that ONESCO is an NASD member and Lancaster was an associated person with ONESCO between March 23, 2004, and January 3, 2005. Under certain circumstances, the NASD Code of Arbitration Procedure can bind its members to arbitrate claims with third parties. *See Kidder, Peabody & Co. v. Zinsmeyer Trusts P'ship*, 41 F.3d 861, 863-64 (2d Cir. 1994). To determine whether the Code governs this dispute between Defendant and ONESCO, the Court must interpret the Code as it would a contract under applicable state law, giving effect to the ordinary meaning of the language used. *See Perry v. Thomas*, 482 U.S. 483, 492 n.9 (1987).

The applicable provision is Rule 10301(a) of the NASD Code, which governs whether a matter is required to be arbitrated even in the absence of an express arbitration agreement:

> Any dispute, claim, or controversy eligible for submission under the Rule 10100 Series between a customer and a member and/or associated person arising in connection with the business of such member or in connection with the activities of such associated persons shall be arbitrated under this Code, as provided by any duly executed and enforceable written agreement or upon the demand of the customer.

This section "contain[s] two prerequisites before an NASD member can be compelled to arbitrate. First, a complaining party must be a "customer" of either the NASD member or an "associated person" of that member, and, second, the "dispute, claim or controversy" must have arisen "in connection with the business of such member." *See, e.g., Wheat, First Sec., Inc. v. Green*, 993 F.2d 814, 820 (11th Cir. 1993); *Gruntal & Co., Inc. v. Steinberg*, 837 F. Supp. 85 (D.N.J. 1993) (same). Defendant cannot satisfy either of these two prerequisites.

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b. Defendant Was Not Customer Of ONESCO, Nor Do His Claims Arise "In Connection With" The Business Of ONESCO.

As against ONESCO, Defendant satisfies neither part of the two-prong test to arbitrate his claims under Rule 10301(a).

First, he was not a "customer" of ONESCO. In short, he kept no accounts, signed no contracts, filled out no applications, indeed, had no contact whatsoever with ONESCO.

Next, because the first prong is not satisfied, the second prong of the test is not even reached with respect to ONESCO. *See Wheat*, 993 F.2d at 820-21 (finding that because investors were not Wheat First customers, "we do not reach the question of whether [the investors'] claims arose 'in connection with the business' " of Wheat First). Nevertheless, *even if* the Court were to consider the second prong, Defendant cannot satisfy it because there is simply no nexus between Defendant's claims and the business of ONESCO. The Private Placement Memorandum expressly states that the securities were not offered through a broker-dealer. ONESCO played absolutely no role in the transactions in question. ONESCO did not authorize the transactions or otherwise have any knowledge of the transactions before they occurred. None of the transactions were effectuated through ONESCO. ONESCO is not identified anywhere in the Private Placement Memorandum or in any of the written materials provided to Defendant by Lancaster. Defendant's only contact was with Lancaster. There is no evidence Lancaster ever made any representation, whether oral or written, concerning ONESCO to Defendant. And, of course, ONESCO received no compensation for any of the transactions.

Courts narrowly construe the second prong of the test, the "in connection with" requirement, and they reject the notion that an investor may arbitrate *all* of his transactions with any NASD member, including those not made in connection with the member's business. As the Eleventh Circuit explained in a recent case, "in the universe of member-customer disputes, only a portion will arise in connection with the member's business and only those satisfy the Code's arbitration provisions." *Multi-Financial Sec. Corp. v. King*, 386 F.3d 1364, 1370 (11th Cir. 2004).

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c. Defendant Was Not Customer Of A Person Associated With ONESCO At The Time Of The Events Giving Rise To His Claims.

So, Defendant is forced to argue that he had a relationship with Lancaster. It is not enough, however, to allege having entered into a transaction with someone who was "associated" with an NASD member at some other time. Rather, as first held in *Wheat, First Securities, Inc. v. Green*, there must be a relationship between the investor and the member or associated person *at the time* of the relevant events or occurrences giving rise to the investor's claims. "Customer status" under the NASD Rules "must be determined as of the time of the events providing the basis for the allegations of fraud." 993 F.2d at 820 ("customer" status for purposes of arbitrability "*should be determined as of the time of the occurrence of events that constitute the factual predicate for the causes of action contained in the arbitration complaint*"). As the *Wheat* court explained: "We cannot imagine that any NASD member would have contemplated that its NASD membership would require it to arbitrate claims which arose while a claimant was a customer of another member merely because the claimant subsequently became its customer. ..." *See MONY Sec. Corp. v. Bornstein*, 390 F.3d 1340 (11th Cir. 2004) (Eleventh Circuit reaffirmed that " 'customer status for purpose of' the NASD is 'determined as of the time of the events providing the allegations.' " *Id.* at 1345 (citing *Wheat* at 820).

In *Wheat, First*, because the claimants "were not customers of Wheat First at the time of the allegedly fraudulent ... stock transactions," the court held they could not "invoke the NASD Code to compel Wheat First to arbitrate." *Id.* As a result, the court affirmed summary judgment on Wheat First's declaratory judgment action, finding that Wheat First could not be compelled to arbitrate. *Id.* at 815.

This legal proposition has been adopted by every court that has considered this issue, including the Southern District of California in *Prudential Sec., Inc. v. Dusch*, 1994 WL 374425 (S.D. Cal., Mar. 28, 1994) (. H).[6] On point with the instant case is *Hornor, Townsend & Kent,*

[6] In *Duscsh*, the investor made investments in accounts established with another NASD member while her stockbroker (the associated person) was associated with that NASD member. Later, Prudential acquired the assets of that NASD member, and the associated person with whom the investor had been dealing moved to Prudential, along with the investor's accounts. Then, additional transactions were made. The court agreed with Prudential that it was not required to arbitrate claims based on investments

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Inc. v. Hamilton, 2004 WL 2284503 (N.D. Ga., Sept. 30, 2004) (Exh. F), wherein the court granted summary judgment to the NASD member, holding that it could not be compelled to arbitrate claims based on investors' transactions with a sales agent that were premised on alleged misrepresentations that occurred before the agent occurred before the agent became associated with the member. In *Hornor*, the facts showed that the investors had made a securities transaction based on alleged misrepresentations made at least *two months* before the agent became associated with Hornor Townsend, the NASD member. Claims arising from those events, therefore, were held not arbitrable. The court explained that, "if the sale occurred at a time when [the associated person] was not employed by [the member], the latter cannot be hauled into an arbitration proceeding . . . ." *Id.* at *3 (citing 2003 WL 23832424, at *4 (earlier ruling in same action)).

In another case involving similar facts, *Gruntal & Co., Inc. v. Steinberg*, 854 F. Supp. 324 (D.N.J. 1994), the court applied *Wheat* to enjoin arbitration, concluding that the investors who were pursuing arbitration were not customers for purposes of an NASD arbitration. There, as here, the pertinent events occurred before the investors became customers of the broker-dealer.

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made *before* the investor's accounts were moved to Prudential. Following *Wheat*, the court held that these claims were not arbitrable because they arose when the investor was not yet a customer of Prudential. *Id.* at *2. *cf: World Group Sec. v. Ko*, 2004 1811145, at *6 (N.D. Cal., Feb. 11, 2004) (holding under similar NASD Rule 10201 that an associated person had no claim against member based on contractual relationship and events occurring before the person was associated with the member).

Other courts have reached this same conclusion. In *Sands Bros. & Co., Ltd. v. Ettinger*, 2004 WL 541846 (S.D.N.Y., Mar. 19, 2004) (Exh. J), the investor sought to arbitrate claims against an NASD member based on the conduct of an associated person with whom she had dealt. But the investor's problem was that the transactions occurred *before* the associated person was associated with the member against whom arbitration was sought. The court followed *Wheat* and concluded that, "Ettinger cannot compel Sands to arbitrate her losses stemming from activity in her account before the account was acquired by Sands. To the extent [the associated person with whom the investor had dealt] engaged in misconduct with respect to her account while at [predecessor brokerages], Ettinger cannot require Sands to arbitrate that claim under the theory that she became a 'customer' of Sands thereafter." *Id.* at *3. *See also Sands Bros. & Co., Ltd. v. Alba Perez Ttee Garcia Revocable Trust*, 2004 WL 2186574, at *4 (S.D.N.Y., Sept. 28, 2004) (Exh. K) (same result as to a different claimant).

And in *Ryan, Beck & Co. v. Fakih*, 268 F. Supp. 2d 210 (E.D.N.Y. 2003), the Eastern District of New York rejected an investor's attempt to arbitrate over a transaction that took place *after* the investor ceased to be a customer of the NASD member, Ryan Beck. There, the investor had terminated his investment relationship with a brokerage that was the predecessor to Ryan Beck. Later, after Ryan Beck acquired the assets of that brokerage, the investor sought to arbitrate claims against Ryan Beck based on transactions occurring in his account while it was with the previous brokerage.

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"Like the acts of fraud involved in *Wheat,*" the court reasoned, "*the misconduct which is the subject of the Arbitration Proceedings took place, in its entirety at least two months before the Steinbergs became customers of Gruntal*." *Id.* at 340 (emphasis added).

The Gruntal court added that the second prong of the arbitrability test also could not be met: "The claims at issue in the Arbitration Proceedings, moreover, did not arise 'in connection with the business of' Gruntal, as is required by the NASD Code of Arbitration Procedure. As indicated, the Arbitration Proceedings relate to acts and omissions occurring over two months before Gruntal had any relationship to the Steinbergs." *Id.* at 341.

d. Applying The Settled Rule Of *Wheat* To The Facts, Defendant May Not Arbitrate His Claims Against ONESCO.

Applying the rule of *Wheat* and its progeny to the facts of this case produces exactly the same result: Defendant's irrevocable commitment to purchase with the Lancorp Fund occurred on July 30, 2003, and was premised on alleged material misrepresentations and/or omissions that occurred before that date – more than seven months before Lancaster became an "associated person" of ONESCO.

ONESCO submits that any activity after Defendant's execution of his Subscription Agreement appears to have occurred outside of Lancaster's tenure with ONESCO, and was otherwise based on the same operative facts relating to the Subscription Agreement and any misrepresentations prior thereto – or what the *Wheat* court described as the same "*occurrence of events that constitute the factual predicate for the causes of action*." 993 F.2d at 820. *See also Malhotra v. Equitable Life Assurance Society of the United States*, 364 F. Supp.2d 299, 305-06 (E.D.N.Y. 2005) (subsequent investment decisions, for purposes of claims premised on fraud and misrepresentation, do not constitute relevant events or occurrences – for purposes of timeliness – unless premised on "*new and materially different*" omissions) (emphasis added); *Northwestern Human Services, Inc. v. Panaccion*, 2004 WL 2166293, at *18 (E.D. Pa. Sept. 24, 2004) ("As a matter of simple logic, any misrepresentation of omission must have occurred on or before the date of sale.") (Exh. L).

In summary, ONESCO "cannot be hauled into an arbitration proceeding" based on the occurrence of events (specifically, alleged misrepresentations by Lancaster) that occurred before he became associated with ONESCO. *Hornor*, 2004 WL 2284503, at *3. Indeed, an NASD member "could not have supervised [the associated person] at a time before [the associated person] became employed with" the NASD member. *Hornor, Townsend & Kent, Inc. v. Hamilton*, Case No. 1:01-cv-02979 (N.D. Ga., Sept. 6, 2005) (slip op., at 12) (Exh. G). As *Wheat* reasoned, "we cannot imagine that any NASD member would have contemplated that its NASD membership would require it to arbitrate claims ... merely because the claimant subsequently became its customer." 993 F.2d at 820.

B. ONESCO Would Suffer Irreparable Harm If Forced To Arbitrate A Dispute It Has Not Agreed To Arbitrate, And Defendant Can Show No Countervailing Hardship.

The Ninth Circuit has clearly spoken that a party is caused irreparable harm if it is forced to arbitrate a dispute where it had no contractual obligation to do so. *See LAWI/CSA Consolidators, Inc. v. Wholesale & Retail Food Distribution, Teamsters Local 63*, 849 F.2d 1236, 1241 n.3 (9th Cir. 1988) (holding that party was entitled to injunctive relief once it established that it was not under a contractual duty to arbitrate). *Accord: Merrill Lynch Investment Managers v. Optibase, Ltd.*, 337 F.3d 125, 129 (2nd Cir. 2003) (unless arbitration is enjoined, movant would suffer irreparable harm by being forced to expend time and resources arbitrating an issue that is not arbitrable and as to which any award would not be enforceable); *MONY Sec., Inc. v. Vasquez*, 238 F. Supp. 2d 1304, 1308 (M.D. Fla. 2002) ("This Court has continuously held that irreparable harm is present if a party is compelled to arbitrate a claim absent an agreement between the parties to arbitrate).

In light of this law, the balance of hardships tips completely in ONESCO's favor, because if Defendant has no right to an arbitration, he will suffer no hardship at all by having to litigate his disputes in court like every other litigant who lacks an agreement to arbitrate.

C. The Public Interest Is Advanced By Not Forcing Parties To Arbitrate Their Disputes Where They Never Agreed To Arbitrate.

Although it is often said that public policy favors arbitration of disputes, that is true only if

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the parties have agreed to arbitrate in the first instance. Arbitration is a creature of contract, and if the parties never had a contract to arbitrate their disputes, then no public interest is advanced by compelling them to arbitrate. Where a court finds that no agreement to arbitrate exists, they do not linger on this factor for even a moment because the public interest is obviously served when a party is not forced to arbitrate a dispute that it never agreed to arbitrate.

IV. CONCLUSION

For the foregoing reasons, ONESCO seeks preliminary injunctive relief (1) enjoining the Defendants from further proceedings in the NASD actions; and (2) enjoining the Defendants from filing any arbitration claims before the National Association of Securities Dealers, Inc. against ONESCO relating to the Lancorp Fund, and requests that the Court schedule a hearing on ONESCO's preliminary injunction motion at a date and time which will allow the parties to conduct reasonable discovery into these issues prior to the hearing.

Respectfully submitted,

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